FINANCIAL MANAGEMENT – PART II

Note: The following words are interchangeable throughout the course: firm, business, organisation, company and practice; product and service; customer, client and patient.

Sources of capital

Clearly the different sources of capital have different risk and cost implications. Share capital and accumulated profits are permanent sources of capital provided at no cost to the business, while loans from an external source are repayable, and carry interest. This is referred to as 'gearing', which simply means the amount of money that is borrowed and that bears interest. The more money you owe to a bank the higher the risk of your company is and the higher your gearing is.

Share capital (or owner's funds)

Share capital refers to the money that the owner uses to start the business. It is meant to be a long-term source of finance, not to be withdrawn from the business within a short period of time. It is also an interest-free source of capital as the practice will not pay the owner interest on the money that is used to start the practice. The owner will instead earn future profits from the business in exchange for depositing the money into the business at this stage.

In a registered company (a Pty Ltd), the shareholders would deposit monies to start the company in the form of share capital. The money deposited into a practice by a sole practitioner or by partners is called the owners' or partners' capital accounts. Share capital or capital accounts paid into a business are meant to be a permanent investment into the business, which can or should only be repaid or withdrawn in exceptional circumstances.

In the case of sole practitioners or partnerships which do not operate in an incorporated company, there are no legal restraints on withdrawing the money that was deposited into the practice. These doctors can determine at their own discretion how much capital they would like to put into the practice and for how long.

In order for a business to be able to continue on a sound financial footing, it needs to have sufficient money available, on a permanent basis, preferably at no cost.

Profits left in the business

Profit that is left in the business and not withdrawn, is an important and valuable resource of funds, called accumulated profits. Accumulated profits, like owners' funds, are an interest-free source of capital to the business, with no fixed repayment terms.

Loans (or loan capital)

Loans from outside lenders, like banks, usually carry interest at a market-related rate, and these loans are repayable over a period of time or by a certain date. The higher the proportion of funds obtained from outside lenders, the more risky the business becomes, as it needs extra funds to meet the interest obligation of the business. In other words, the practice needs to make more money to attain the same profits, as some of the money is paid to outside lenders in order to pay interest on borrowed money.

Applications of capital in a business

As mentioned earlier, there are three main uses or applications of funds in a business, namely: fixed assets, working capital, and investments.

Fixed assets

Fixed assets are the items purchased which the business intends to keep and to use for the purposes of generating income. Examples of fixed assets are practice equipment, property, vehicles, computers and office furniture. Some medical practices require larger investments in assets than others, for example radiologists and pathologists. These disciplines usually operate in group practices to make this initial lay-out more affordable to the individual doctor, and to lower the risk by sharing the cost of the fixed assets. We refer to this as 'economies of scale'. The larger the scale of operation, the more cost-effective it becomes to the individual.

Working capital

Working capital refers to the net total of all short-term current assets and short-term current liabilities, which are either in cash, or intended to be turned into cash within a 12-month period. Working capital is also referred to as trading capital. It is the amount of money that a business earns in the short term from debtors, minus the amount of money that it needs to pay to all the debtors and other overheads. The accepted norm is that trading assets should exceed trading liabilities, which will result in an excess of trading assets compared with liabilities.

Examples of trading assets are accounts receivable, stock (dispensing drugs), and cash on hand and in the bank.

Examples of trading liabilities are accounts payable, bank overdraft, and other amounts due and payable within a 12-month period, e.g. tax payable and audit fee.

Investments

Investments are any surplus amounts of money that the business put aside in order to earn interest on, or to grow in value, until the business requires such funds. Examples are share portfolios, savings in the bank etc.

Key success factors in managing finances

There are four key success factors that the practice manager needs to focus on when managing finances: profitability, cash flow, debt and asset management, and overall coordination of all financial resources.

The following chapters deal with each of the above four key success areas in greater detail.

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